

CHAPTER 1

OVERVIEW

1.1 Introduction

There is a long history of questions about financial reporting standards and the needs of small entities, the users of their financial statements, and the professionals who serve those entities. Some contend that standards designed for large entities fail to meet the needs of small, often closely held, entities (IASB, 2002). As such, accountants are becoming increasingly aware of the special and specific needs of small business.

The issue of the application of accounting standards to small companies has been a controversial issue for many years, and the subject of numerous studies around the world. However, the debate generally revolves around one principal issue: whether accounting standards should apply equally to all financial statements that intend to be a fair presentation, or whether small companies should be exempted from the unduly burdensome requirements of some accounting standards. (Koppeschaar, 2002)

The problem with applying present accounting standards to smaller companies stems partly from their nature and partly from the weight and complexity of the accounting standards for which the costs of consideration and compliance outweigh the usefulness or relevance of the disclosed information. Small companies are often run by a small number of shareholders who, along with tax authorities and financial institutions, are the main financial statement users. Small companies do not have the same financial reporting needs as large companies do. They differ in their ownership interests, management, and the effects of external parties. The complex calculations and the quantity of disclosure frequently required by accounting standards make the

financial statements of small companies often incomprehensible to their users. Small companies are being compelled to disclose information to their shareholders irrespective of usefulness or relevance. (Koppeschaar, 2002)

1.2 Purpose of the Study

The notion of differential reporting suggests that certain reporting entities may be exempted from the application of specific accounting standards because of their size, legal structure, ownership and or the presence of a dependent user (Nair & Rittenberg, 1983; McCahey & Ramsey, 1989).

International studies have generally concluded that small business managers perceive the costs of complying with accounting standards to be greater than the benefits. This is due to their perception that there are a limited number of users requiring such data and that compliance with accounting standards may disclose strategic information to competitors (Nair & Rittenberg, 1983; Carsberg, Page, Sindall & Waring, 1985).

As mentioned earlier, small business enterprises (SBEs) financial statement users are usually few in number, being mainly bankers, owner/managers, tax authorities and, in certain instances, venture capital providers. Generally SBEs prepare GAAP financial statements primarily to satisfy the needs of their bankers. Even though in these circumstances, bankers consider financial statement credibility to be very important and they seek assurance that GAAP have been complied with; nonetheless, bankers are aware of the financial reporting burden of SBEs and are receptive to the idea of alleviating it. The other basic characteristic of SBEs is that they are not usually active in financial markets. Besides, SBE financial statement users can usually obtain additional information if they so wish. (Lavigne, 1999)

Many experts felt that accounting by SMEs is an important topic that needed to be addressed urgently. In any economy, there were many different-sized businesses and that a single accounting framework would therefore ignore economic reality. Therefore, a system should be created which were internally consistent and allowed enterprises a logical progression from one to another level in line with company growth.

The Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) at its 18th Session decided to adopt a three-tier system of differential reporting in order to meet the financial reporting needs of small and medium-sized enterprises.

Level 1 would apply to listed entities whose securities are publicly traded and those in which there is 'significant public interest'. These enterprises would be required to apply full IASs.

For Level 2 commercial and business enterprises that do not issue public securities or financial reports to the general public, the application of full IASs might be beyond their needs and costs would outweigh benefits. Therefore, it is felt that a condensed set of rules for smaller businesses could be particularly useful.

Level 3 would apply to the smallest entities that are often owner-managed and have few employees. They would do simple accruals based accounting, while new entrants would be allowed to use cash accounting for a brief period or limited time when first establishing their accounting system.

A present, the MASB is generally of the view that it is not appropriate to grant qualifying enterprises full exemption from both the accounting treatment and disclosure provisions of its accounting

guide the preparation and presentation of exempt enterprise reporting. The Board has decided that the most appropriate decision is to grant *partial exemptions* on a standard by standard basis (MASB SOP 1).

Therefore, the primary purpose of this research is to explore the suggestions put forth by the ad hoc consultative group of experts on accounting by small and medium-sized enterprises commissioned by ISAR in UNCTAD. The importance of conducting this study is to investigate whether MASB should introduce differential reporting in Malaysia as practiced in the UK, Canada and New Zealand.

The findings may be useful for MASB to consider whether there is a need to develop a proposed framework comprising three levels of entities (three-tier system of differential reporting) as suggested by UNCTAD. Information gathered from this study would be beneficial to companies that meet the definition of 'exempt enterprise' if MASB introduced differential reporting. They would be allowed to follow a set of simplified accounting rules instead of complying with the full application of accounting standards, in recognition of the fact that external financial reporting imposes a heavy burden on small and closely-held entities and whether, in long-term, this approach will reduce compliance costs and accounting standards overload.

1.3 Problem Definition

The most important difference between a small business and a listed public company lies in the nature of ownership: the former is characterised by the entrepreneur or family investing their own capital and running the business; the latter, in stark contrast, is virtually always run by professional managers acting on behalf of Institutional investors who own the majority of shares. It

is this divorce of ownership and control that creates the need for directors to be held accountable to shareholders. (John & Healeas, 2000)

According to the accounting framework, the objective of preparing financial statements is to supply information to users to make relevant economic decisions. The profile and needs of the respective users should be the determining factor when deciding on the small or large enterprise distinction. Other criteria that seemed appropriate would be based on the composition of an entity's membership and management.

The question of whether SMEs should be subject to the same accounting standards requirements as larger companies has been raised frequently, especially in view of the rapid changes in other jurisdictions such as in the UK, New Zealand and Canada which have adopted differential reporting.

As the information needs and cost/benefit effectiveness differ for SMEs, this research seeks to find out from practitioners of chartered accountancy firms in Malaysia whether they favour the three-tier accounting system as proposed by UNCTAD to be implemented in Malaysia. Besides, this study also seeks to find out these practitioners' opinion on the proposed guidelines on accounting by SMEs for Level 2 and Level 3 that should be adopted if the three-tier accounting system is being implemented by MASB and what are the implementations issues would be.

1.4 Methodology and Data Collection

An explanatory nature of study is selected because there has been no study of a similar nature being carried out in the Malaysian context.

A survey will be conducted in order to find out from practitioners of chartered accountancy firms what they think on the proposed 'three-tier' approach as suggested by ISAR. A self-administered questionnaire will be sent out to approximately 980 practitioners of chartered accountancy firms registered with the Malaysian Institute of Accountants in Malaysia.

1.5 Limitations

This research is confined to opinions from practitioners of chartered accountancy firms and members from the SMEs were not included. Some preliminary fact finding in the form of discussions were conducted with a few practitioners of small and medium-sized public practices, and found out the followings:

- Generally, most of the members from the SMEs are not aware of the MASB SOP 1 as these owner-managers are too preoccupied with the day to day running of the businesses. These companies typically the small ones, have limited accounting staff that are capable of recording the daily accounting transactions and rudimentary information systems. Some do not even have a proper accounting system. They rely heavily on the (often expensive) services of small or medium sized audit firms to handle all of its accounting affairs and also its audit as well.
- The situation of the medium-sized companies are slightly better as they do engage someone to handle their accounts and prepare simple financial statements because they have higher volume of daily accounting transactions involved. Nevertheless, the person employed to carry out such task is normally technically unqualified and also not well versed in most of the MASB standards or SOPs.

In order to validate these limitations mentioned above, two questions have been structured to find out from the targeted respondents in relation to the quality of accounting staff employed and adequacy of quality accounting systems being used in these small and medium sized companies.

1.6 Conclusion

It is viewed that the findings obtained on the proposed sample of this research will provide empirical evidence or useful information whether MASB should considers making any changes to the Statement of Principle. The next chapter seeks to identify existing literature bearing relevance to this research.